IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

No. [illegible]

PENNSYLVANIA POWER & LIGHT COMPANY,
Petitioner,

v.

FEDERAL POWER COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF

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To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioner, Pennsylvania Power & Light Company, respectfully prays that a writ of certiorari be issued to review the decree of the United States Circuit Court of Appeals for the Third Circuit entered in the above cause on December 7, 1943 (R. 607), pursuant to decision of that Court rendered on the same date, affirming orders of the Federal Power Commission dated April 14, 1942 and June 10, 1942, determining the actual legitimate original cost of Petitioner's Wallenpaupack power project.

Statutes Involved

The statutes involved are the Federal Water Power Act of 1920 (41 Stat. 1063-1077) and the Federal Power Act of 1935 (49 Stat. 838-863; 16 U. S. C. A. §§ 791a-825r). Primary concern is with Section 4(a) of the former Act (41 Stat. 1065) as originally enacted and as amended by Section 202 of the latter Act (49 Stat. 839; 16 U. S. C. A. § 797(b)) dealing with determination of net investment in a license project, and with the definition of "net investment" contained in Section 3 of the former Act (41 Stat. 1064) and continued in the latter Act (49 Stat. 838; 16 U. S. C. A. § 796(13)). Other provisions involved are Section 14 of the Federal Water Power Act as originally enacted (41 Stat. 1071) and as amended by the Federal Power Act (49 Stat. 844; 16 U. S. C. A. § 807); Section 28 of the Federal Water Power Act (41 Stat. 1077); and Sections 201(a) and 301(a) of the Federal Power Act (49 Stat. 847; 16 U. S. C. A. § 824, and 49 Stat. 854; 16 U. S. C. A. § 825, respectively).

Opinions Below

The opinions of the Federal Power Commission were filed April 14, 1942 (Appendix, 483a-527a) and June 10, 1942; the latter opinion denied rehearing with respect to issues here involved (Appendix, 541a, 542a)*.

The opinion of the Circuit Court of Appeals (R. 592-607) is reported in 139 F. (2d) 445.

* The Appendix to Petitioner's Brief in the Circuit Court of Appeals has been certified to this Court and constitutes the printed record on which the case was heard in the Court below. Hereafter this Appendix will be cited merely by page references followed by the letter "a," and all such references are to the Appendix, unless the Record in the Court of Appeals, designated "R" followed by page number, is indicated.

Jurisdiction

The decree of the Circuit Court of Appeals sought to be reviewed was entered December 7, 1943 (R. 607). Rehearing was denied on February 11, 1944 (R. 621). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended (28 U. S. C. A. § 347a).

Questions Presented

(1) May the Federal Power Commission in determining the "actual legitimate original cost" of a licensed power project, as those terms are defined in Section 3 of the Federal Water Power Act of 1920 (41 Stat. 1064), adopt retroactively as to a project constructed during the years 1924 to 1926, the so-called "no profit to affiliates" rule embodied for the first time as a matter of Federal statutory policy in the Public Utility Act of 1935 (Title I, Section 13(b), 49 Stat. 825, 15 U. S. C. A. § 79m(b)), of which the Federal Power Act of 1935 is Title II?

(2) Where the Federal Water Power Act of 1920 provides that "net investment" in a project means the actual legitimate original cost thereof as defined and interpreted in the "classification of investment in road and equipment of steam roads, issue of 1914, Interstate Commerce Commission," and this provision is reenacted in identical language in the Federal Power Act of 1935, may the Federal Power Commission disregard interpretations by the Interstate Commerce Commission allowing charges paid to affiliates as proper costs, such interpretations being made after the passage of the 1920 Act but before the Act of 1935?

(3) May the Commission also disregard the settled law established by prevailing judicial decisions at the time the project was constructed in favor of its new and different conception of public policy, as expressed in its "no profit to affiliates" rule?

(4) Even if the items disallowed were properly removed from the project costs under the rule adopted by the Commission, may they be ordered removed from all asset accounts by charge to earned surplus, as those accounts appear in Petitioner's fundamental corporate books kept subject to State laws and the requirements of State authorities?

Statement

The decision below was rendered upon a petition filed under Section 313(b) of the Federal Power Act of 1935 (49 Stat. 860, 16 U. S. C. A. § 825-1(b)), by Pennsylvania Power & Light Company for review of orders of the Federal Power Commission determining the actual legitimate original cost of Petitioner's Wallenpaupack power project.

The Wallenpaupack Project was constructed by Petitioner during the years 1924 to 1926 under license dated September 29, 1924, issued by the Commission in the usual form for such licenses for projects on navigable streams under the Federal Water Power Act of 1920 (41 Stat. 1063; 16 U. S. C. A. §§ 791, *et seq.*) for a term of fifty years. Pursuant to the requirements of the Act and of the license, Petitioner filed with the Commission in due course, its statement of actual legitimate original cost which, as supplemented by annual statements of additions, et cetera, to December 31, 1934, claimed a total cost of $9,148,755.88. After investigations of this statement and hearings thereon, the Commission issued its Opinion No. 68 and Order dated April 14, 1942, in which it found the actual legitimate original cost to December 31, 1934 to be $8,573,895.70, and directed that $540,574.74* of the amount

* By Order dated September 29, 1942, after rehearing this charge was reduced to $500,721.12 (563a) but not affecting the items involved in this petition.

disallowed be removed not only from the project accounts, but from every asset account of the Petitioner, and charged to earned surplus (483a-527a).

Included among the items disallowed and ordered charged to surplus were charges of Petitioner's controlling affiliate or parent company, Electric Bond and Share Company (Bond and Share), consisting of a construction fee of $197,596.35 paid to Bond and Share's construction subsidiary Phoenix Utility Company (Phoenix), and $93,629.87 of the engineering charges made by the engineering department of Bond and Share.*

The entire Phoenix fee was disallowed solely because it represented compensation in excess of the identifiable overhead cost to Phoenix or Bond and Share, and therefore constituted a "profit" (489a-496a) and $84,555.75 of the engineering charges were disallowed for the same reason, the profit, however, being computed by a redetermination by the Commission's staff, adopted by the Commission, of the overhead charges allocated to engineering by Bond and Share (497a-509a).

The Phoenix fee was based upon a construction contract which in effect provided for a fee of 3% on the contractual base cost (116a, 568a), and the engineering fee was based on an engineering contract supplemented by work orders which provided for the payment of salary cost of engineers and department employees assigned to the work, plus a conventional overhead which, although stated somewhat differently in the different work orders, aver-

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* This petition for certiorari presents directly only the questions of disallowance and accounting disposition of the Phoenix construction fee and the Bond and Share engineering overhead charge. If the Commission and court action should be reversed on account of these disallowances, recalculation of interest during construction would necessarily follow as a matter of mechanics. The remaining disallowances, while we disagree with them, we do not believe justify resort to this Court.

aged about 95% of the base salary cost (374a-375a). Bond and Share in its books of account (184a-206a), Haskins & Sells, its auditors (206a-226a), and the Federal Trade Commission in its utility investigation (227a-231a), supported the overhead charge, but the Commission made an independent recalculation of overhead of 50% of salaries, and disallowed the balance as profit (308a-408a, Opinion, 497a-509a).

To state the facts in detail would unduly prolong this petition. It is sufficient to say here that every element involved in proof of the necessity for and reasonableness of the charges was fully shown (54a-65a, 148a-182a). Petitioner had no experienced staff, or equipment, to do the engineering or construction work; was obliged to go outside of its own organization for the work and selected Bond and Share for the purpose, though not compelled so to do (54a-65a, 96a-97a, 102a). The work was entirely done by Bond and Share and its subsidiary construction company without aid or assistance of Petitioner (100a-116a, 143a-144a). The work was well done, economically done, and the charges made were reasonable both as related to cost and as to charges which would be made by non-affiliated companies (148a-182a, 480a-482a). The Commission in its opinion stated, in substance, that the issue is not one of reasonableness, but of control, and control existing, no profit is allowable (489a-490a, 497a).

On May 13, 1942, Petitioner filed with the Commission its Application for Rehearing, setting forth, *inter alia*, that the Commission erred in these disallowances and the disposition thereof (528a-540a).

On June 10, 1942, the Commission denied rehearing on the issues here involved (541a-542a). On August 5, 1942, a petition for review of the Commission's action in the matters above stated was filed in the Circuit Court of Ap-

peals for the Third Circuit (543a-559a). That Court in all respects affirmed the decision of the Commission (R. 607).

In order to relate and confine the factual discussion to the legal questions involved, we premise that Section 3 of the Federal Water Power Act of 1920 (41 Stat. 1064) defines "net investment" in a project as "the actual legitimate original cost thereof as defined and interpreted in the 'classification of investment in road and equipment of steam roads, issue of 1914, Interstate Commerce Commission,' plus similar costs of additions thereto and betterments thereof * * *." This definition is continued in the Federal Power Act of 1935, Section 3(13) (49 Stat. 838; 16 U. S. C. A. § 796). Under "General Instructions," page 9, item 1 of this classification, it is stated that the prescribed accounts are designed to show the investment of the "carrier" in property and that the "carrier" means the "accounting carrier," and on page 10, item 2, it is stated that costs shall be the "actual money costs" to the "carrier."

The basic rules governing original cost determination were set forth by the Interstate Commerce Commission in *Texas Midland Railroad*, 75 I. C. C. 1, 176 (1918) in a manner which we believe, and shall argue, is in principle conclusive of the question here involved. At the time of the passage of the Federal Water Power Act of 1920 that case was the guiding authority used and referred to in Congress for the adoption of the statutory definition (Cong. Rec., 65 Cong. 2d Sess., p. 9957). At the time of such passage there had been no express interpretation by the Interstate Commerce Commission applying to the specific problem of contracts between affiliates, the principles outlined in the *Texas Midland* case.

But subsequent to the passage of the Act of 1920, and prior to the passage of the amended Act of 1935, the Interstate Commerce Commission had before it in many cases

the question whether costs paid by a carrier to an affiliated construction or supply company were to be allowed, and uniformly sustained all such payments as original cost to the carrier, without differentiating between them and payments made to non-affiliated contractors. For illustration see *Southern Pacific Co., et al.*, 45 I. C. C. Val. 1, 12 (1933), *Atlantic City & Shore Railroad Co.*, 125 I. C. C. 353, 356, 370, 371 (1927); *cf. Brimstone Railroad & Canal Co.*, 141 I. C. C. 445, 446 (1928); *Mobile & Gulf Railroad Co.*, 43 I. C. C. Val. 309, 314, 316 (1933); *Chaffee Railroad Co.*, 43 I. C. C. Val. 925-927, 935 (1933). For a further application of the I. C. C. ruling made subsequent to 1935, see *Pullman Company*, 47 I. C. C. Val. 501 (1936).

The Court below, however, cites a ruling of the Federal Power Commission in the case of *Louisville Hydro-Electric Company*, 1 F. P. C. 130 (1933) and the Fourteenth Annual Report of the Commission on December 1, 1934, as supporting the "no profit to affiliates" rule, and concludes in effect, that the subsequent reincorporation in the 1935 Act of the 1920 definition of actual legitimate original cost does not incorporate the intervening interpretations of this classification by the Interstate Commerce Commission (Opinion, R. pp. 594-589).

We submit that this ruling of the Court below accords to the Power Commission the authority to erect standards of conduct not only in excess of those authorized by the statute under which it acts, but in direct contravention of those statutory standards.

There can be little doubt that the recognition of the possibility, if not probability, of "evils" in contracts between a controlling company and its controlled affiliate have prompted not only increased judicial scrutiny, but express legislative condemnation of such contracts. The Public Utility Act of 1935 (49 Stat. 803-863), of which the Federal Power Act is Title II, contains as Title I, the Public Utility

Holding Company Act. In Section 13 of this Act (49 Stat. 825; 15 U. S. C. A. § 79m) Congress for the first time expressly prohibited inter-company service and construction contracts at a profit in public utility holding company systems. But that Act, while approved on August 26, 1935, postpones the effective date of this prohibition to April 1, 1936, thus recognizing the widespread existence of such contracts, and the legality, so far as Congress is concerned at least, of their continued performance for a period of some eight months after approval of the Act.

The holding of the Commission in this case sustained by the Court below condemning this "profit" solely because of the fact of affiliation and without regard to other circumstances, gives *retroactive* application to a *prospective* statutory regulation. There can be no question that during the period of the construction of this project (1924-1926) the courts, in a long line of decisions, recognized the legitimacy of these contracts if fair and reasonable, and their validity was dependent not on the intrinsic fact of affiliation but on extrinsic considerations of reasonableness. *Missouri ex rel. Southwestern Bell Telephone Company* v. *Public Service Commission*, 262 U. S. 276 (1923), *Smith* v. *Illinois Bell Telephone Company*, 282 U. S. 133 (1930), *Western Distributing Co.* v. *Public Service Commission of Kansas*, 285 U. S. 119 (1932), and *Dayton Power & Light Co.* v. *Public Utilities Commission of Ohio*, 292 U. S. 290 (1934). These decisions have been uniformly followed by Federal District Courts. A few of the cases are cited in the margin.*

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* *Southwestern Bell Tel. Co.* v. *San Antonio*, 75 F. (2d) 880, 883 (C. C. A. 5, 1935), cert. den. 295 U. S. 754 (1935); *Illinois Bell Tel. Co.* v. *Gilbert*, 3 F. Supp. 595, 602 (N. D. Ill. 1933); *Pacific Tel. & Tel. Co.* v. *Whitcomb*, 12 F. (2d) 279, 284, 285 (W. D. Wash. 1926); *Southern Bell Tel. & Tel. Co.* v. *Railroad Commission*, 5 F. (2d) 77, 86, 97 (E. D. S. C. 1925); *Northwestern Bell Tel. Co.* v. *Spillman*, 6 F. (2d) 663 (D. Neb. 1925); *Indiana Bell Tel. Co.* v. *Public Service Commission*, 300 Fed. 190, 204 (D. Ind. 1924); *Southern Bell Tel. & Tel. Co.* v. *Railroad Commissioners*, 299 Fed. 615 (E. D. S. C. 1923); *Chesapeake & Potomac Tel. Co.* v. *Whitman*, 3 F. (2d) 938, 957 (D. Md. 1925); *New York Tel. Co.* v. *Prendergast*, 36 F. (2d) 54, 63, 67 (S. D. N. Y. 1929).

It is perfectly apparent from a cursory reading of the decision of the Commission (see particularly pp. 489a-499a) and of the Court (R. 597-601) as against the relevant portions of the testimony (61a-182a*) that the decision of both Commission and Court is based upon the social philosophy inherent in the "no profit to affiliates" theory, and not on the record facts which the Commission should have found or at least considered and passed upon in this particular case. In other words, we do not have an administrative finding of relevant facts, but refusal to consider such facts because of the adoption of standards created *ad hoc* by the Commission itself.

The facts of affiliation are nowhere in dispute. Bond and Share, to whom the fees were paid, owned fifteen per cent. of the voting stock of Petitioner's controlling holding company, Lehigh Power Securities Corporation (55a-56a, 490a). Notwithstanding this minority interest in stock it had, through voting trust arrangements, interlocking directorates and servicing arrangements, working control of Petitioner. If such affiliation *per se* destroyed the validity of any profit element in intercompany contracts under existing law at the time these contracts were performed, the decision was correct. If the facts of necessity of the services, efficiency and economy of their performance, and the reasonableness of the charges out of which the profit was generated, are relevant, the decision was erroneous as contrary to the uncontradicted evidence in the record.

The order of the Commission, affirmed by the Court below, directed that disallowed items be removed not only from the project accounts, but also from all asset accounts

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* See particularly 61a-65a, 86a-87a, 89a-116a, 131a-182a.

by charge to earned surplus. This surplus appears on the fundamental corporate books of Petitioner, which are kept under the authority of the laws of the Commonwealth of Pennsylvania. The accounting jurisdiction of the Federal Power Commission is defined in Section 301(a) of the Federal Power Act of 1935 (49 Stat. 854, 16 U. S. C. A. § 825). This section expressly permits the maintenance of such accounts and records as are required to be kept by or under authority of the laws of any State.

Furthermore, assuming the propriety of the order directing the removal of these charges from project accounts for purposes of administration, a direction to remove them entirely from Petitioner's asset accounts by charge to surplus would appear to conflict with the right of Petitioner to preserve the charges on its records to support its claims of cost and value in any situation in which they may be relevant, and specifically for final determination of its net investment by agreement with the Commission or decree of the Federal District Court in pursuance of Section 14 of the Federal Water Power Act of 1920 (41 Stat. 1071). While this section was amended by the Federal Power Act of 1935 (49 Stat. 844, 16 U. S. C. A. § 807) giving the Commission the right to determine net investment, Section 28 of the 1920 Act provided that no amendment should affect any license theretofore issued, and Article 24 of the license here involved (Appendix, p. 9a) preserved this right to the Licensee.

Specification of Errors

1. The Circuit Court of Appeals erred in sustaining the order of the Federal Power Commission disallowing as part of the project costs the computed construction and engineering profits of Phoenix Utility Company and Electric Bond and Share Company as determined by the Commission.

2. The Circuit Court of Appeals erred in sustaining the order of the Federal Power Commission requiring disallowed items of project cost to be charged to earned surplus of the Petitioner, Pennsylvania Power & Light Company.

Reasons Relied on for Allowance of Writ

1. Substantial issues and questions of federal law of far reaching importance are involved in this case. These questions appear from the foregoing statement, but may be formally posed as follows:

> Whether an administrative agency, specifically the Federal Power Commission, may erect standards of judgment for the determination of matters entrusted to it in conflict with the standards prescribed by the act of its creation and with recognized principles of then existing law. (See *Securities and Exchange Commission* v. *Chenery Corporation*, 318 U. S. 80, 92, 93 (1943); *U. S.* v. *Bethlehem Steel Corporation*, 315 U. S. 289, 308, 309 (1942).)

> Whether the Federal Power Act of 1935 in reenacting the definition of "net investment" as "actual legitimate original cost," "as defined *and interpreted* in the classification of investment in road and equipment of steam roads" of the Interstate Commerce Commission, did not require the Federal Power Commission to follow the interpretations of the classification adopted by the Interstate Commerce Commission between the date of the passage of the original and the passage of the amendatory act. (Emphasis supplied.)

U. S. v. *Dakota-Montana Oil Co.*, 288 U. S. 459, 466 (1933);

Johnson v. *Manhattan Ry. Co.*, 289 U. S. 479, 500 (1933);
Koshland v. *Helvering*, 298 U. S. 441, 445 (1936).

2. It is believed that the decision of the Court below is in conflict with the uniform tenor and holdings of applicable decisions of this Court.

Reduced to its simplest terms the Court below has held baldly that any profit, no matter how reasonable, in relation either to costs to the contractor or competitive charges in similar work between unaffiliated companies is "illegitimate," *i. e.*, unlawful, where a controlling affiliation is established. While the particular decision is limited to project costs under the Federal Water Power Act, the only basis for rejection of the charges disallowed is that they are "illegitimate." How far reaching such a principle, if established, would be it is impossible to predict.

We submit that such a ruling is in conflict with the decisions of this Court hereinbefore cited (see p. 9, *supra*). The only cases cited by the Court below in support of the ruling, viz., *Alabama Power Company* v. *McNinch*, 94 F. (2d) 601 (App. D. C. 1937) and *Alabama Power Company* v. *Federal Power Commission*, 134 F. (2d) 602 (C. C. A. 5, 1943), are clearly distinguished in fact from the case here involved, and the *McNinch* case at least clearly recognizes the allowance of reasonable profit under the factual circumstances disclosed by the record here. (See 94 F. (2d), at pp. 617, 618.)

3. The precedent established by this Court in this case should be determinative of a great number of controversies presently pending before the Federal Power Commission and which may otherwise require judicial decision.

There are in the Electric Bond and Share system some 30 major hydro-electric projects, of which, in addition to the Wallenpaupack project in the Third Judicial Circuit, one is in the Fourth Circuit, four are in the Eighth Circuit, fourteen in the Ninth Circuit and ten in the Tenth Circuit. The same or substantially similar questions to those involved in this particular case are involved in most of these projects, and the decision here should be determinative in all Circuits.*

Affiliated engineering and construction organizations have been employed in many if not most other holding company systems. While doubtless substantial factual differences exist which may govern the application of the legal principles, the precedent here established should be of great value in determining similar issues which might be raised in those systems.

4. The decision of the Circuit Court of Appeals sustaining the order of the Federal Power Commission directing that the disallowed items be charged to earned surplus appears to be in conflict with the decision of the Fifth Circuit Court of Appeals in *Alabama Power Company* v. *Federal Power Commission*, 134 F. (2d) 602 (1943).

The Fifth Circuit Court in the case cited held that jurisdiction of the Power Commission extended solely to accounts set up and maintained under its jurisdiction and not as here to accounts maintained under State authority and supervision (134 F. (2d) at p. 611).

5. The order of the Federal Power Commission affirmed by the Court below in directing the removal of dis-

* The present case was selected by the Commission apparently as a test case, the decision in which should be controlling in all other cases in this system. In some cases we are advised that stipulations have been made that final decision of those cases will follow the final decision in this case. In others we understand that no such stipulations have been made.

allowed items from all asset accounts by charge to earned surplus directs the charge-off of "items of continuing value," apparently contrary to the decision of this Court in *American Tel. & Tel. Co.* v. *United States*, 299 U. S. 232 (1936).

The recent decision of this Court in *Northwestern Electric Company* v. *Federal Power Commission*, 64 S. Ct. 451 (1944), does not dispose of but appears to reserve the questions here presented. The items of cost ordered written off here were costs to Petitioner for services actually received by Petitioner of a value at least equal to the cost thereof. These items do not involve cost to a holding company stockholder for securities later purchased. The order here would appear to raise *inter alia* the question of conflict of jurisdiction suggested at the close of the opinion in the *Northwestern* case.

Conclusion

Wherefore, Petitioner respectfully prays that a writ of certiorari be issued to the United States Circuit Court of Appeals for the Third Circuit in accordance with the practice of this Court, and that a hearing upon and determination by this Court of the matters presented be had.

Dated, March 8, 1944.

Respectfully submitted,

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BRIEF FOR THE [illegible]

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PENNSYLVANIA POWER & LIGHT COMPANY,
PETITIONER

v.

FEDERAL POWER COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the circuit court of appeals (R. 592–607) is reported in 139 F. (2d) 445. The opinions and orders of the Commission are set forth in the record (R. 483–527; 541–542; 560–564).

JURISDICTION

The judgment of the circuit court of appeals (R. 607) was entered on December 7, 1943. A petition for rehearing was denied on February 11, 1944 (R. 621). The petition for a writ of

certiorari was filed on March 8, 1944. Jurisdiction of this Court is invoked under Section 313 (b) of the Federal Power Act (49 Stat. 860, 16 U. S. C. 825*l*) and Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the Federal Power Commission, in determining the "actual legitimate original cost" of petitioner's licensed project, properly disallowed as items of cost profits inuring to petitioner's parent holding company under construction and service contracts with petitioner.

2. Whether the Commission properly required petitioner to charge the disallowed items to surplus.

STATUTES INVOLVED

The relevant provisions of the Federal Water Power Act of 1920 and the Federal Power Act of 1935 are set forth in the Appendix, *infra,* pp. 16–19.

STATEMENT

Under a license dated September 29, 1924, issued by the Federal Power Commission pursuant to the Federal Water Power Act of 1920,[1] petitioner, the Pennsylvania Power & Light Company, constructed the Wallenpaupack hydroelectric project on the Lackawaxen River in Pennsylvania (R.

[1] By Title II of the Public Utility Act of 1935 (49 Stat. 838), the Federal Water Power Act was amended and made Part I of the Federal Power Act of 1935.

5–10). As required by section 4 (b) of the Act and by the license (R. 7), petitioner in 1928 filed with the Commission a statement of the claimed "actual legitimate original cost" of the project, which, as supplemented by subsequent annual statements of additions, betterments, and retirements, totalled $9,148,755.88 as of December 31, 1934. After service upon petitioner of a report showing the results of an audit made by the Commission's staff (R. 12–35), and extensive hearings thereon, the Commission determined the actual legitimate original cost of the project as of December 31, 1934, to be $8,579,186.15; the balance of petitioner's claimed cost was disallowed (Commission's Opinion No. 68 and orders of April 14, 1942, as amended September 29, 1942; R. 483–527, 562–564). Petitioner was directed to set up its accounts to reflect the Commission's determination by removing the disallowed amounts from its project accounts and charging them to various accounts, principally the earned surplus account (R. 524–527). As to the issues here involved, petitioner's application for rehearing (R. 528–540) was denied by the Commission (R. 541–542), and on a petition for review, the Commission's determination was upheld by the Circuit Court of Appeals for the Third Circuit (R. 607).

The disallowances of which petitioner complains in this Court (Pet. 5–6) are limited to the profits ($84,555.75) obtained by petitioner's parent holding company, Electric Bond and Share Company

(Bond & Share), for engineering services furnished to petitioner under a "service" contract, and the profits ($197,596.35) derived by Bond & Share from a cost-plus construction contract between its wholly-owned subsidiary, Phoenix Utility Company (Phoenix), and petitioner.

The following facts relating to the disallowance of these items were found by the Commission and are uncontested here:

Petitioner was organized by Bond & Share on June 4, 1920, by consolidating certain previously acquired Pennsylvania utility companies (R. 497; 54). Bond & Share owned only 15% of the voting stock of a sub-holding company controlling petitioner, but maintained complete working control over petitioner through a voting trust, interlocking directorates, and servicing arrangements (R. 498, 499; Pet. 10). As to the engineering and construction work in question here, there was an absence of arm's length bargaining between Bond & Share and petitioner (R. 495).

Under a contract with petitioner, the engineering department of Bond & Share provided designs and specifications for the project, in return for which petitioner reimbursed Bond & Share for the salaries paid to its employees who did the work, plus approximately 95% of the salaries to cover overhead (R. 500). The Commission found that the properly allocable overhead was 50% of the salaries (R. 509), and that the remaining 45% of the overhead charge constituted a profit of $84,-

555.75 to Bond & Share, which the Commission disallowed under its rule that profits to an affiliate are not to be included within "actual legitimate original cost" (R. 509–511).

Under a contract calling for cost plus a 3% fee, Phoenix, a wholly-owned subsidiary of Bond & Share, performed construction work on the project (R. 565–569). Phoenix had no personnel or equipment of its own and did not operate with its own funds; it operated only within the Bond & Share system, obtaining none of its contracts as a result of competitive bidding; its officers and employees were supplied and paid by Bond & Share or operating companies in the system; and its construction equipment was purchased with funds of the operating company (R. 491). When it undertook the construction work for petitioner, Phoenix created an organization under its own name, the salaries being paid by petitioner; and the profits obtained by Phoenix were immediately siphoned into Bond & Share's treasury (R. 493). The Commission further found that Phoenix was merely the separately incorporated construction department of Bond & Share, interposed for the purpose of exacting construction fees from operating companies controlled by Bond & Share (R. 495). The Commission therefore held that the 3% fee of $197,596.35 over costs, paid to Phoenix by petitioner, was a profit to an affiliate and did not constitute a part of the "actual legitimate original cost" of the project (R. 495).

On petition for review, the court below affirmed the Commission's order (R. 593–607).

ARGUMENT

Petitioner contends that the Commission is not authorized to disallow profits to petitioner's affiliates as not within "actual legitimate original cost," and to direct that the disallowed amounts be charged to earned surplus. We submit that this contention was properly rejected by the court below.

1. The Commission's exclusion of Bond & Share's profits from the "actual legitimate original cost" of petitioner's licensed project was justified under sections 4 (b) and 3 (13) of the Federal Power Act of 1935. Section 4 (b) authorizes and empowers the Commission "to determine the actual legitimate original cost of and the net investment in a licensed project." Section 3 (13) defines "net investment" in a project to mean "the actual legitimate original cost thereof as defined and interpreted in the 'classification of investment in road and equipment of steam roads, issue of 1914, Interstate Commerce Commission', plus similar costs of additions thereto and betterments thereof * * *. The term 'cost' shall include, insofar as applicable, the elements thereof prescribed in said classification * * *." Both of these provisions are derived from sections 3 and 4 (a) of the Federal Water Power Act of

1920, 41 Stat. 1063, with which they are substantially identical. (See Appendix, pp. 16–19, *infra*.)

The "classification of investment in road and equipment of steam roads" was issued in 1914 by the Interstate Commerce Commission in compliance with the requirement of the Valuation Act of 1913, 37 Stat. 701, that the "original cost" of the physical properties of carriers subject to its jurisdiction be investigated and determined by the Commission (18 Code of Federal Regulations, Part 103, pp. 209, *et seq.*). The classification provided, so far as may be relevant here, that "the cost of construction shall include * * * contract work" (*id.*, p. 216), and that "cost of contract work includes amounts paid for work performed under contract by other companies" (*id.*, p. 217). It contained no provision, however, dealing with situations in which the construction work was done by an affiliated company. And when Congress enacted the Federal Water Power Act of June 10, 1920, the Interstate Commerce Commission had made no rulings upon the question whether construction profits to affiliates should be allowed. *Texas Midland R. R.*, 75 I. C. C. 1, 176 (1918), upon which petitioner relies, did not involve that question. As the court below held, the issue in that case was "whether in determining the cost of a project the amounts actually expended by the carrier or the fair average cost must prevail," and the Commission "ruled in favor of the amounts actu-

ally expended" (R. 597). Compare *Kansas City Southern Ry.*, 75 I. C. C. 223, 233 (1919).

After the passage of the Federal Water Power Act of 1920 the Federal Power Commission formulated and consistently applied its "no profit to affiliates" rule. *E. g., Alabama Power Company, Licensee* (Mitchell Dam), 1 F. P. C. 25, 31, 39, P. U. R. 1932 D, 345, 352, 360; *Chelan Electric Company, Licensee,* 1 F. P. C. 102, 108, P. U. R. 1933 E, 332; *Louisville Hydro-Electric Co., Licensee,* 1 F. P. C. 130, 133–136, 1 P. U. R. (N. S.) 454, 458–461. The rationale of the rule was thus stated by the Commission in its opinion in the *Louisville Hydro-Electric* case, *supra,* at 136:

> * * * Where there is admitted control of both the licensee and the service company and where, as here, the two companies are virtually departments of an integrated system, the Commission must, under the provisions of the Federal Water Power Act, disregard the contract and hold that cost to the licensee can be no more, though it may under certain circumstances be less, than the cost of such service to the service company. * * *

These decisions were reported annually to the Congress, and in its Fourteenth Annual Report, transmitted to Congress on December 1, 1934, the Commission called attention to the holding company problem and the interpretation which it had given to the phrase "actual legitimate original cost":

> * * * the Commission has sought to protect the public interest by denying claims of costs for services to the licensee, performed by holding companies or affiliated service corporations, pending production by the licensed operating company of the original records of cost. In considering such claims the Commission holds that "cost to the licensee can be no more, though it may under certain circumstances be less, than the cost of such service to the service company" (p. 2).

Thereafter Congress enacted the Federal Power Act of 1935, 41 Stat. 1063, which retained without change the statutory criterion of "actual legitimate original cost" in section 4 and its definition in section 3. Such reenactment of the cost criterion in the Federal Water Power Act of 1920 implies Congressional acquiescence in the Federal Power Commission's long-settled administrative construction of the phrase "actual legitimate original cost" to exclude the allowance of profits to affiliates in determining cost. Here, as in *Inland Waterways Corp.* v. *Young*, 309 U. S. 517, 525, "the responsible and pervasive practice of public officers bent on safeguarding the public interests ought to carry the day even were the issue more in doubt than we believe it to be." The Federal Power Commission since 1935 has adhered to the "no profit to affiliates" rule, consistently disallowing such items as proper elements of cost. *E. g., Northern States Power*

Company, Licensee, 1 F. P. C. 329, 344–345; *Lexington Water Power Company, Licensee,* 1 F. P. C. 430, 435–469; *Alabama Power Company, Licensee,* 2 F. P. C. 432, 443–444, 41 P. U. R. (N. S.) 449; *Puget Sound Power & Light Company, Licensee,* F. P. C. Op. 78, July 28, 1942.

In providing in section 3 of the 1920 Act that "actual legitimate original cost" should be regarded "as defined and interpreted" in the classification of railroad properties issued by the Interstate Commerce Commission in 1914, Congress clearly did not intend to bind the Federal Power Commission and the courts in construing that phrase to whatever interpretations might subsequently be made by the Interstate Commerce Commission in determining the valuation of properties owned by carriers. (See Hearings before the House Committee on Water Power (65th Cong., 2d Sess.), March 18 to April 4, 1918, Part I, p. 44.) It is immaterial, therefore, whether subsequent to the enactment of the Federal Water Power Act of 1920 the Interstate Commerce Commission failed to differentiate between profits of affiliated and non-affiliated contractors.[2] As the court below noted

[2] With the exception of *Texas Midland Railroad,* 75 I. C. C. 1 (1918) which admittedly did not involve contracts between affiliates (Pet. 7), all the I. C. C. decisions cited by petitioner were rendered subsequent to 1920. See Pet. 8. Since the disallowance of profits here was based on sections 4 (b) and 3 (13) of the Federal Power Act, these considerations are dispositive of petitioner's contention (Pet. 9) that the Com-

(R. 598), these cases "have no bearing on the question before us since they could not have been in the contemplation of Congress when it passed the [1920] act."

As the court below pointed out, profits to affiliated companies are neither "actual" nor "legitimate" items of cost, since "payment of profits to an affiliated corporation may for all practical purposes be the equivalent of payment of profits to the licensee itself" (R. 599).

Bond & Share's actual investment in petitioner was small (only 15% in an intermediate holding company which owned petitioner's common and most of its voting stock), and it exercised complete control by means of a voting trust, interlocking directorates, service contracts, and other arrangements (Pet. 10).[3] Normally Bond & Share would receive only a fraction of any dividends which petitioner declared from its operating income (R. 490), and to realize more substantial profits, Bond & Share applied its "fee system" to pe-

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mission was retroactively applying the "no profit to affiliates" rule of the S. E. C. embodied in section 13 of the Public Utility Holding Company Act (15 U. S. C. 79m), and in disregard of the line of decisions which deal with the reasonableness of the affiliates' charges. None of the cases relied upon by petitioner involved the statutory standard of "actual legitimate original cost" as applied to licensees.

[3] The so-called Mitchell Plan under which Bond & Share exercised control of subsidiaries with little or no actual investment is described in *In the Matter of Electric Bond and Share Company, et al.*, S. E. C. Holding Company Act Release No. 3750.

titioner. Through its control over petitioner, Bond & Share obtained the execution by petitioner of cost-plus and other contracts with itself and Phoenix, under which construction, engineering, and other services were rendered to petitioner at fees and rates fixed without any arm's length dealing (R. 489–511). As the court below characterized the relationship of the companies, "Phoenix and the licensee are thus both puppets in the Electric Bond and Share system" (R. 601).

To permit petitioner's asset accounts to reflect an amount representing merely a profit to its affiliated companies fixed without any element of independent negotiation, would result in the "inflation of cost" which Congress intended to prohibit by establishing the standard of "actual legitimate original cost" for licensees. See *Alabama Power Company* v. *McNinch*, 94 F. (2d) 601, 618 (App. D. C.).[4]

The construction given the statute by the court below is in accord with that consistently made by all of the courts which have considered the matter. Whenever the question has arisen, whether under

[4] Actual legitimate original cost controls the price which the Government must pay upon recapture of the project at the expiration of the license (§ 14). It is also the basis for expropriation of excess profits (§§ 10 (d) and (e)), compensation for wartime or emergency use of the project by the United States (§ 16), and rate regulation by the Commission (§§ 19 and 20). Cf. *United States* v. *Appalachian Electric Power Co.*, 311 U. S. 377.

the Federal Water Power Act of 1920 or the Federal Power Act of 1935, the courts have uniformly sustained the Commission's disallowance of profits to affiliates in determining actual legitimate original cost. *Alabama Power Company* v. *McNinch,* 94 F. (2d) 601, 608, 615, 618 (App. D. C.) (under 1920 Act); *Alabama Power Company* v. *Federal Power Commission,* 128 F. (2d) 280, 284 (App. D. C.), certiorari denied, 317 U. S. 652 (under 1935 Act); *Alabama Power Company* v. *Federal Power Commission,* 134 F. (2d) 602, 609 (C. C. A. 5), (under 1935 Act); *Puget Sound Power & Light Company* v. *Federal Power Commission,* 137 F. (2d) 701, 703 (App. D. C.), (under 1935 Act); *Niagara Falls Power Company* v. *Federal Power Commission,* 137 F. (2d) 787, 793–794 (C. C. A. 2), No. 448 Oct. Term 1943, certiorari denied, November 22, 1943 (under 1935 Act).

2. The Commission's requirement that petitioner charge the disallowed items to earned surplus was properly sustained by the court below. In this aspect the case "presents only a question of proper accounting." *Northwestern Electric Company* v. *Federal Power Commission,* No. 195, this term, decided January 31, 1944. A sound and reasonable manner of removing from the project accounts an item not representing actual legitimate original cost is to charge the improper item to surplus. Substantially identical accounting procedure has uniformly received judicial approval. *Alabama Power Company* v. *Federal*

Power Commission, 128 F. (2d) 280, 285–286 (App. D. C.), certiorari denied, 317 U. S. 652; *Louisville Gas & Electric Company* v. *Federal Power Commission,* 129 F. (2d) 126, 133–134 (C. C. A. 6), certiorari denied, 318 U. S. 761; *Niagara Falls Power Company* v. *Federal Power Commission,* 137 F. (2d) 787 (C. C. A. 2), No. 448, Oct. Term 1943, certiorari denied November 22, 1943; *Northern States Power Company* v. *Federal Power Commission,* 118 F. (2d) 141, 144 (C. C. A. 7); *Alabama Power Company* v. *Federal Power Commission,* 134 F. (2d) 602 (C. C. A. 5); *Puget Sound Power & Light Company* v. *Federal Power Commission,* 137 F. (2d) 701 (App. D. C.). And this Court has recently upheld the elimination of an erroneous asset item by charges to surplus. *Northwestern Electric Company* v. *Federal Power Commission, supra.*

Petitioner urges that the questions presented are important, involving 30 hydroelectric projects of Bond & Share subsidiaries situated in several circuits (Pet. 14). We suggest, however, that review of these issues by this Court at the present time is unwarranted by the circumstances. As has been noted (*supra,* pp. 13–14), there is no conflict in the decisions of the lower courts. The authority of the Commission to apply its "no profit to affiliates" rule in determining cost has been upheld by every court which has considered the question. In view of the correctness of this construction of the

statute, as well as the absence of any conflict in the decisions, further review at this time is not called for.

CONCLUSION

It is respectfully submitted that the petition for a writ of certiorari should be denied.

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MARCH 1944.

APPENDIX

Section 3 (13) of the Federal Power Act of 1935, 49 Stat. 839 (16 U. S. C. sec. 796 (13)) provides as follows:

> (13) "net investment" in a project means the actual legitimate original cost thereof as defined and interpreted in the "classification of investment in road and equipment of steam roads, issue of 1914, Interstate Commerce Commission", plus similar costs of additions thereto and betterments thereof, minus the sum of the following items properly allocated thereto, if and to the extent that such items have been accumulated during the period of the license from earnings in excess of a fair return on such investment: (a) Unappropriated surplus, (b) aggregate credit balances of current depreciation accounts, and (c) aggregate appropriations of surplus or income held in amortization, sinking fund, or similar reserves, or expended for additions or betterments or used for the purposes for which such reserves were created. The term "cost" shall include, insofar as applicable, the elements thereof prescribed in said classification, but shall not include expenditures from funds obtained through donations by States, municipalities, individuals, or others, and said classification of investment of the Interstate Commerce Commission shall insofar as applicable be published and promulgated as a part of the rules and regulations of Commission;

Section 4 (b) of the Federal Power Act of 1935, 49 Stat. 839 (16 U. S. C. sec. 797 (b)) authorizes and empowers the Commission—

(b) To determine the actual legitimate original cost of and the net investment in a licensed project, and to aid the Commission in such determinations, each licensee shall, upon oath, within a reasonable period of time to be fixed by the Commission, after the construction of the original project or any addition thereto or betterment thereof, file with the Commission in such detail as the Commission may require, a statement in duplicate showing the actual legitimate original cost of construction of such project, addition, or betterment, and of the price paid for water rights, rights-of-way, lands, or interest in lands. The licensee shall grant to the Commission or to its duly authorized agent or agents, at all reasonable times, free access to such project, addition, or betterment, and to all maps, profiles, contracts, reports of engineers, accounts, books, records, and all other papers and documents relating thereto. The statement of actual legitimate original cost of said project, and revisions thereof as determined by the Commission, shall be filed with the Secretary of the Treasury.

Section 301 (a) of the Federal Power Act of 1935, 49 Stat. 854 (16 U. S. C. sec. 825), provides as follows:

SECTION 301. (a) Every licensee and public utility shall make, keep, and preserve for such periods, such accounts, records of cost-accounting procedures, correspondence, memoranda, papers, books, and other records as the Commission may by rules and regulations prescribe as necessary or appropriate for purposes of the administration of this Act, including accounts, records, and memoranda of the generation, transmission, distribution, de-

> livery, or sale of electric energy, the furnishing of services or facilities in connection therewith, and receipts and expenditures with respect to any of the foregoing: *Provided, however,* That nothing in this Act shall relieve any public utility from keeping any accounts, memoranda, or records which such public utility may be required to keep by or under authority of the laws of any State. The Commission may prescribe a system of accounts to be kept by licensees and public utilities and may classify such licensees and public utilities and prescribe a system of accounts for each class. The Commission, after notice and opportunity for hearing, may determine by order the accounts in which particular outlays and receipts shall be entered, charged, or credited. The burden of proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing, or requiring such entry, and the Commission may suspend a charge or credit pending submission of satisfactory proof in support thereof.

Section 4 (a) of the Federal Water Power Act of 1920, 41 Stat. 1063, 1065, provided, in part, as follows:

> In order to aid the commission in determining the net investment of a licensee in any project, the licensee shall, upon oath, within a reasonable period of time, to be fixed by the commission, after the construction of the original project or any addition thereto or betterment thereof, file with the commission, in such detail as the commission may require, a statement in duplicate showing the actual legitimate cost

> of construction of such project, addition, or betterment, and the price paid for water rights, rights of way, lands, or interest in lands.

Section 3 of the Federal Water Power Act of 1920, 41 Stat. 1063, 1064–65, defined "net investment" and "actual legitimate original cost" as follows:

> "Net investment" in a project means the actual legitimate original cost thereof as defined and interpreted in the "classification of investment in road and equipment of steam roads, issue of 1914, Interstate Commerce Commission," plus similar costs of additions thereto and betterments thereof, minus the sum of the following items properly allocated thereto, if and to the extent that such items have been accumulated during the period of the license from earnings in excess of a fair return on such investment: (a) Unappropriated surplus, (b) aggregate credit balances of current depreciation accounts, and (c) aggregate appropriations of surplus or income held in amortization, sinking fund, or similar reserves, or expended for additions or betterments or used for the purposes for which such reserves were created. The term "cost" shall include, insofar as applicable, the elements thereof prescribed in said classification, but shall not include expenditures from funds obtained through donations by States, municipalities, individuals, or others, and said classification of investment of the Interstate Commerce Commission shall insofar as applicable be published and promulgated as a part of the rules and regulations of the commission.

U. S. GOVERNMENT PRINTING OFFICE 1944